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How Dodd-Frank Impacts Creditors Of Bankrupt Banks

Law360, New York (March 25, 2014, 1:21 PM ET) -- On Feb. 11, the three private plaintiff-appellants and 11 state plaintiff-appellants in State National Bank of Big Spring et al. v. Jacob J. Lew et al. filed briefs with the U.S. Court of Appeals for the District of Columbia Circuit in their appeal of the district court's decision that the plaintiffs lacked standing to challenge certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

The plaintiff-appellants challenged the "orderly liquidation authority" granted to the FDIC under Title II of the Dodd-Frank Act on the basis that such authority supplants Chapters 7 and 11 of the Bankruptcy Code and thereby strips the plaintiff-appellants of the statutory protections, amounting to property rights, afforded by the Bankruptcy Code to unsecured creditors.

Judge Ellen Segal Huvelle found this argument insufficient to satisfy the standing requirement imposed by Article III of the Constitution, stating that "[while] it is true that Dodd-Frank empowers the [Federal Deposit Insurance Corporation] to treat creditors' claims somewhat differently than they are treated in traditional bankruptcy proceedings ... no one can know if this will ever happen."

The plaintiff-appellants argue that the challenged provisions are facially invalid, rendering the probability of harm test irrelevant, because "[f]or creditors of large financial institutions, Title II of the Dodd-Frank Act expressly ends one of the Bankruptcy Code's core statutory rights: creditors' express right to be repaid equally with other similarly situated creditors."

Title II of the Dodd-Frank Act establishes a new receivership process under which the FDIC will liquidate large interconnected "financial companies" that pose a systemic risk to the U.S. financial system, entities whose insolvencies would have been resolved in bankruptcy proceedings prior to the enactment of Dodd-Frank.

The two requirements for an entity to become subject to this receivership process rather than a proceeding under Chapter 7 or 11 of the Bankruptcy Code are (1) the entity is a "financial company" under Section 202 of the act, and (2) the prospect of its default causes the secretary of the treasury to make a positive systemic risk determination pursuant to Section 203 of the act. Satisfaction of these two conditions causes the entity to be classified as a "covered financial company" that is subject to the appointment of the FDIC as its receiver.

Whether an entity is a “financial company” depends on certain definitions incorporated into Section 202 of the Dodd-Frank Act from the Bank Company Holding Act. The systemic risk determination under Section 203 requires the secretary to consider, among other things, whether:

(1) the company is in default or in danger of default,

(2) the company’s default would have a serious adverse effect on the financial stability of the United States if its resolution were governed by a different federal or state law procedure,

(3) any viable private sector alternative exists, and

(4) the Bankruptcy Code is appropriate for the company’s resolution.

If the requirements of Sections 202 and 203 are satisfied, the entity is considered a “covered financial company” and is subject to an FDIC receivership. The directors and officers of the covered financial company can either acquiesce to the appointment of the FDIC as its receiver or contest it.

If they elect to contest it, a judge in the U.S. District Court for the District of Columbia reviews the secretary’s determination, under a sealed petition, solely to determine whether the secretary’s determinations that the covered financial company is in default or in danger of default and satisfies the definition of a “financial company” were arbitrary and capricious.

The secretary’s other determinations are presumptively valid, Section 202(a)(1)(A), and the FDIC’s appointment and the financial company’s liquidation will commence automatically if the petition is not ruled upon within 24 hours, Section 202(a)(1)(A).

The plaintiff-appellants are challenging the treatment of unsecured claims under the Dodd-Frank Act once a receivership is commenced. Pursuant to Section 210(b)(4), the FDIC is given the authority to treat similarly situated creditors of a covered financial company differently if it is “necessary” to:

(1) maximize the value of the company’s assets;

(2) begin or continue operations that are essential to the liquidation of the company or a bridge company;

(3) maximize the purchase price of the company and/or its assets; or

(4) minimize the loss realized from a sale of the company and/or its assets.

In no event, however, is an unsecured creditor to receive less than it would receive if the FDIC had not been appointed receiver and the company instead had been liquidated under Chapter 7 of the Bankruptcy Code, Section 210(d)(2).

The Dodd-Frank Act seems to jettison the principle of nondiscrimination, a hallmark of the Bankruptcy Code in both reorganization and liquidation cases, in favor of potential prejudice to certain classes of unsecured creditors.

Under Chapter 7 of the Bankruptcy Code, similarly situated creditors are entitled to pro rata payments on their claims in a liquidation, 11 USC §726(b), while Chapter 11 provides for equal treatment of claims that are part of the same class in a reorganization of the debtor, 11 USC §1123(a)(4).

In contrast, the plaintiff-appellants claim that the Dodd-Frank Act strips two protections from creditors: (1) the guarantee of nondiscrimination among other unsecured claimholders and (2) the availability of the Bankruptcy Code to a distressed entity. “Absent these protections and other rights defined in the Bankruptcy Code ex ante, default (or even the fear of default) could spur creditors to ‘race for assets, not necessarily just to grab more than his share but also simply to avoid being left with nothing.’”

Furthermore, the recovery cap of 210(d)(2), says the plaintiff-appellants, ties the value of claims to a sinking ship since the “‘liquidation value [of a covered financial company] is likely to be close to zero.’”

Most importantly, the plaintiff-appellants assert citing numerous scholars and financial institutions, is the effect such uncertainty will have on the capital markets: bondholders are now going to demand a premium for this uncertainty, limiting the access some entities will have to the debt capital markets.

The soon-to-be released new bank leverage ratio may work to provide a favorable playing field for the FDIC should it become liquidator of a covered financial company pursuant to the act. The U.S. has long had in place a leverage ratio of 4 percent with a denominator of only on-balance sheet assets. The FDIC has proposed a ratio of 5 percent for bank-holding companies and 6 percent for insured bank depositories, the former a financial company under the Dodd-Frank Act.

Additionally, the new ratio would see an enlarged denominator that includes all off-balance sheet transactions, including derivatives. The new ratio would incentivize banks to sell riskier assets, making them smaller and more easily managed in Title II liquidation.

The defendant-appellees have not yet filed briefs, and oral argument in the case has not yet scheduled.

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